

<b>BASIC CONCEPTS</b>	
<b>Vouching</b>	<p>The act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:</p> <ul style="list-style-type: none"> <li>(i) that the date of the voucher falls within the accounting period;</li> <li>(ii) that the voucher is made out in the client's name;</li> <li>(iii) that the voucher is duly authorised;</li> <li>(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and</li> <li>(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.</li> </ul> <p>After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.</p>
<b>Audit of cash</b>	<p><b>A. General Considerations</b></p> <ul style="list-style-type: none"> <li>(i) Internal Control System</li> </ul>

<p><b>transactions</b></p>	<ul style="list-style-type: none"> <li>(ii) Correctness of book-keeping records</li> <li>(iii) Observance of accounting principles.</li> <li>(iv) Evidence of Transactions.</li> <li>(v) Validity of Transactions</li> <li>(vi) Disclosure in the Final Accounts</li> </ul> <p><b>B. Casting or Totalling</b></p> <p>Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. Where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced</p> <p><b>C. Bank Reconciliation Statement</b></p> <p>Bank reconciliation is an important accounting control. It is expected the students will be familiar with the method of preparing Bank Reconciliation Statement, as described in the text book. A copy of the statement duly signed by the accountant of the client after it has been checked, should be kept in record by the auditor along with other working papers, for future reference.</p>
<p><b>General Considerations</b></p>	<p>In addition to matters which are listed in the audit of cash transactions, certain other principal matters that should be taken into account while vouching trading transactions are:</p> <ul style="list-style-type: none"> <li>(i) Correctness of book-keeping record</li> <li>(ii) Observance of accounting principles</li> <li>(iii) Checking of inventory and records</li> </ul>
<p><b>Internal Control in Respect of Trading Transactions</b></p>	<p>Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc. The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for. It is, therefore, the duty of the auditors to see that the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the fore goings.</p>

<b>Internal Control in Respect of Services</b>	The provision of service also constitutes trading, e.g., those rendered by a contractor, estate agent, repairer of motorcars, etc. In those cases, the internal check should provide for the regulation of the charges for the services rendered, either according to an agreement entered into with the parties, to whom the services have been provided, or on the basis of costs incurred in providing the service, a record in respect whereof is maintained. It is the duty of the auditor to verify that an appropriate internal check exists in respect of different types of transactions entered into by the client to ensure that all the income receivable has been properly accounted for and adequate precautions have been taken to control expenses.
<b>Cut-off arrangement</b>	It is the arrangement where the transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained.
<b>Balance Sheet Audit</b>	<p>A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts which are so closely related to these items that it cannot be properly verified without such analysis and test.</p> <p><b>External confirmation</b> is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.</p> <p>The process of external confirmations, ordinarily, consists of the following:</p> <ul style="list-style-type: none"> <li>◆ Selecting the items for which confirmations are needed.</li> <li>◆ Designing the form of the confirmation request.</li> <li>◆ Communicating the confirmation request to the appropriate third party.</li> <li>◆ Obtaining response from the third party.</li> <li>◆ Evaluating the information or absence thereof</li> </ul>

**Question 1**

*How will you vouch and/or verify the following:*

(a) *Goods sent out on Sale or Return Basis.*

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(b) *Borrowing from Banks.*

**Answer**

**(a) Goods Sent Out on Sale or Return Basis:**

- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- (ii) See that price of such goods is unloaded from the sales account and the trade receivable's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
- (iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.
- (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing inventory.

**(b) Borrowing from Banks:** Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

- (i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- (ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
- (v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Question 2**

*"No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the bank". Give your comments and observations.*

**Answer**

**Cheques Received on the Last Day of Accounting Year:** It is quite normal that in any ongoing business entity many a times cheques are received from the customers on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the trade receivables' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the trade receivables' ledger should ensure that proper accounting entries have been passed by crediting respective trade receivables' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

**Question 3**

*How will you vouch/verify the following:*

- (a) *Goods sent on consignment.*
- (b) *Foreign travel expenses.*
- (c) *Receipt of capital subsidy.*
- (d) *Provision for income tax.*

**Answer****(a) Goods Sent on Consignment:**

- (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

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- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
  - (v) See that goods in hand with the consignee have been shown distinctly under inventories.
- (b) Foreign Travel Expenses:
- (i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
  - (ii) Verify that the tour programme was properly authorised by the competent authority.
  - (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
  - (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
  - (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company, the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".
- (c) Receipt of Capital Subsidy:
- (i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
  - (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
  - (iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
  - (iv) Check relevant entries for receipt of subsidy.
  - (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

**(d) Provision for Income Tax:**

- (i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

**Question 4**

*'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss.*

**Answer**

**Vouching of Payments:** Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

- (i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;
- (ii) a transaction pertains to entity and took place during the relevant period;
- (iii) all transactions which have actually occurred have been recorded;
- (iv) all transactions were properly authorised; and
- (v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

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Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records.

### Question 5

*How will you, as an auditor, vouch and/or verify the following:*

- (a) *Deferred Revenue Expenditure.*
- (b) *Goodwill.*

### Answer

- (a) **Deferred Revenue Expenditure:** This is a type of revenue expenditure, whose benefit extends to more than one accounting year during which it is actually incurred. Accountancy principles require that only that part of the expenditure which is pertaining to the accounting period should be charged to the Statement of Profit and Loss of the year. Remaining amount should be carried forward in the Balance Sheet and it should be written off against the future income, depending upon the number of years during which the benefit of expenditures is likely to be enjoyed. This type of expenditure is known as deferred revenue expenditure. Part of such revenue expenditure is to be treated as assets for the purpose of disclosure in the balance sheet for the time till the benefit of such expenditure is fully exhausted.

While verifying deferred revenue expenditure, the auditor may satisfy himself that:

- (i) it is proper to defer the expenditure;
- (ii) the period of amortisation of the expenditure is reasonable;
- (iii) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
- (iv) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue / other benefits related to the expenditure continue to exceed the amount of unamortized expenditure.
- (v) the necessary principles laid down under AS 26 "Intangible Assets" have been examined, to ensure whether such kind of deferment is allowed to be made or not.

**(b) Goodwill:**

- (i) Ensure that goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
- (ii) Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.
- (iii) See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.
- (iv) See whether goodwill has been written off as a matter of financial prudence as per the principles enunciated under AS 26 on Intangible Assets.

**Question 6**

*How will you vouch and/or verify the following:*

- (a) *Sale proceeds of Scrap Material.*
- (b) *Trade Marks and Copyrights.*
- (c) *Machinery acquired under Hire-purchase system.*
- (d) *Work-in-progress.*

**Answer****(a) Sale Proceeds of Scrap Material:**

- (i) Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
- (ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.
- (iii) Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.
- (iv) Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.
- (v) Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.
- (vi) See that scrap materials sold have been billed and check the calculations on the invoices.

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- (vii) Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it.
  - (viii) Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness.
- (b) Trade Marks and Copyrights:
- (i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
  - (ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trade marks and copyrights have been duly registered.
  - (iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.
  - (iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trade marks and copyrights have been capitalised.
  - (v) Ascertain that the legal life of the trade marks and copyrights have not expired.
  - (vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.
- (c) Machinery Acquired Under Hire-Purchase System:
- (i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.
  - (ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, and terms of payment and rate of purchase.
  - (iii) Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.
  - (iv) Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account.
- (d) Work-in-Progress: The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-

progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows-

- (i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.
- (ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.
- (iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimated cost expected.
- (iv) Ensure that the allocation of overhead expenses had been made on a rational basis.
- (v) Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.
- (vi) Ensure that the Work-in-Progress as at Balance Sheet date has been appropriately disclosed in Balance Sheet as per the requirements of Part I of Schedule III of the Companies Act, 2013.

#### Question 7

*State briefly how you will verify the following:*

- (a) *Bank Balances.*
- (b) *Bills Payable.*

#### Answer

##### (a) Bank Balances:

- (i) Verify bank balance by reference to bank statements.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment.
- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) Check the disclosure requirement in the Balance Sheet as per Part I of Schedule III to the Companies Act, 2013 in the case of a company.

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- (b) **Bills Payable:** These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:
- (i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.
  - (ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.
  - (iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.
  - (iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.
  - (v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

### Question 8

*Write a short note on "Cut-off arrangement".*

### Answer

**Cut-off Arrangement:** Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as "cut-off arrangement". It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:

- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
- (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

**Question 9**

*"It is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems". Comment.*

**Answer**

**Verification of Sale Proceeds of Scrap:** An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary course of his duties the auditor would expect that scrap generated in the company, if any, are properly accounted for. The existence of an accounting and costing system would provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which the scrap have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor.

Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

**Question 10**

*While conducting the audit of the accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply risen in comparison to the previous year. State the steps you would take to satisfy yourself.*

**Answer**

**Causes for Increase in the Rate of Gross Profit on Sales:** There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year. The most likely causes are as under-

- (i) **Increase in Sales Prices:** The selling price of the finished products may have been increased. Enquiries should be made by auditor as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.
- (ii) **Reduction in Cost of Manufacturing:** The cost of manufacturing may have reduced substantially. The auditor should examine the inventory and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.
- (iii) **Alteration in Sales-mix:** The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.

- (iv) **Impact of Automation:** The mechanisation or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.
- (v) **Adherence to Cut-off Procedures:** The company cut-off procedures as regards closing inventory and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.
- (vi) **Manipulating Sales:** The possibility of items which have been sent to customers on 'sale or return' basis being included in sales should be investigated, as this would give effect for increase in the rate of gross profit.

**Question 11**

*How will you verify/vouch the following:*

- (a) *Sales Commission Expenditure.*
- (b) *Sales Return.*

**Answer**

**(a) Sales Commission Expenditure:**

- (i) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes, the commission should be in accordance with the terms and conditions as specified.
- (ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.
- (iii) Ensure that the sales in fact have taken place and the same has been charged to Statement of Profit and Loss.
- (iv) Compare the amount incurred in previous years with reference to total turnover.
- (v) Check entries regarding TDS on commission at the time of credit to Payee's Account, or payment, whichever is earlier.
- (vi) Ensure that the payment has been made through cheque only, if limit as stated in the clause of tax audit is exceeded.

**(b) Sales Return:**

- (i) Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.
- (ii) Verify by reference to relevant corresponding record in good inward book or the stores records. Further, the figures in these documentary evidences should be compared

with the original invoices for rates and other charges and calculation should also be checked.

- (iii) Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.
- (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

#### Question 12

*Write a short note on "Vouching".*

#### Answer

**Vouching:** The act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transaction recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of transaction on its inclusion in the final statements of account. After examination, each voucher is marked in a manner to ensure that it may not be presented again in support of another entry. The following points need careful consideration while examining a voucher:

- (i) that the date of the voucher falls within the accounting period;
- (ii) that the voucher is made out in the client's name;
- (iii) that the voucher is duly authorised;
- (iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
- (v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

#### Question 13

*"Travelling expenses of ₹ 2.25 lakhs shown in Statement of Profit and Loss of X Ltd., including a sum of ₹ 1.10 lakhs spent by a Director on his foreign travel for company's business accompanied by his mother for her medical treatment". Comment.*

**Answer**

**Personal Expenses Charged to Revenue Account:** The auditor should check the service contract, minutes of board meeting, etc., to check the authorisation for such expenditure.

As per the provisions of Section 143(1) of Companies Act, 2013, the auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer.

In this case, the auditor should examine documentary evidence in support of the travelling expenses of ₹ 1.10 lakhs incurred by the director and ascertain the personal component thereof. Then, he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report.

**Question 14**

*How will you verify/vouch the Purchase return?*

**Answer**

**Purchase Return:**

- (i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.
- (ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in this documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.
- (iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.
- (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

**Question 15**

*Write a short note on "Scrutiny of General Ledger".*

**Answer**

**Scrutiny of General Ledger:**

- (i) The General Ledger contains all the balances which are ultimately included in the Statement of Profit and Loss and the Balance Sheet. Its examination therefore is undertaken last of all.

- (ii) The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.
- (iii) Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.
- (iv) It should also be ascertained that balances in all the income and expense accounts have been adjusted: (a) according to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued Income and pre-recorded income is properly adjusted); and (b) on a consideration of the legal provisions which are applicable to the concern.
- (v) The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

#### Question 16

*While conducting the audit of accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply decreased in comparison to the previous year. State the steps you would take to satisfy yourself.*

#### Answer

**Decrease in Rate of Gross Profit on Sales:** When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause decrease in the Gross Profit of the manufacturing company-

- (i) Undervaluation of closing inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking .
- (ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory valued at cost which is below the market price.
- (iii) Inclusion in the current year, the amount of goods purchased in the previous year, that were received and taken in the same year.
- (iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
- (v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
- (vi) Excess provision for wages or direct expenses have been made.
- (vii) Goods sent out for sale on approval or on a consignment basis not included in closing inventory.

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- (viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.
- (ix) Expenses which should be charged in the Profit and Loss Account but wrongly charged to the Trading Account.
- (x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
- (xi) Goods sold or given as samples or destroyed, not accounted for.

### Question 17

*SMT Enterprises entered into a contract for sale of its goods worth ₹ 24 lacs with ST Ltd. The goods were inspected, approved and finalised by the inspection team of ST Ltd. ST Ltd. made the whole payment of ₹ 24 lacs. However, it requested SMT Enterprises to dispatch the goods in six equal monthly instalments from October, 2015 to March, 2016. In the month of January, 2016, due to natural calamity, ST Ltd. informed SMT Enterprises to stop dispatches of the remaining three instalments until further notice. At the time of finalising its accounts for the financial year 2015-16, SMT Enterprises booked sales amounting to ₹ 12 lacs and showed remaining ₹ 12 lacs as Advance against Sales. Comment.*

### Answer

**Recognition of Revenue:** Accounting Standard 9 on Revenue Recognition, requires that revenue from sale of goods should be recognized when the following conditions are followed-

- (i) The seller has transferred the property in the goods for a price to the buyer or all significant risks and rewards of ownership have been transferred to the buyer, and the seller has not retained effective control of the goods transferred to a degree usually associated with ownership.
- (ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

In the given case, the sale transaction carried by SMT Enterprise fulfills all the condition stated above. Hence, the accounting entry passed by SMT Enterprise recognising partial revenue to the extent of goods dispatched is not correct. The entire amount of ₹ 24 lakhs should be recognised as sales.

### Question 18

*How will you vouch and/or verify the Premium paid for insurance of a Motor car?*

### Answer

**Premium Paid for Insurance of a Motor Car:** Vouch from the following-

- (i) Insurance cover note issued by the insurance company verifying the car no. and period of insurance coverage.

- (ii) Verify that “no claim bonus” is given, where entitled, by the Insurance Company.
- (iii) Ensure that proper adjustment is made for prepaid insurance premium.

**Question 19**

*How will you vouch/verify the following:*

- (a) *Liability towards gratuity.*
- (b) *Expenditure incurred for promotion of a product.*
- (c) *Balances with excise authority.*
- (d) *Receipt of special backward area subsidy from Government.*

**Answer****(a) Liability Towards Gratuity:**

- (i) The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.
- (ii) The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined.
- (iii) The auditor should treat the actuary as an expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 620.
- (iv) The auditor should check the technical competence of actuary, the input fed to the actuary, the assumptions made by the actuary, the methodology adopted by the actuary, opinion given etc.
- (v) The auditor should bear in mind the relevant pronouncements of AS 15 “Employee benefits” in this regard. He should check whether the expenses of provision for gratuity are towards a defined benefit plan or contribution plan.
- (vi) If the contributions are made to outside agency, say the insurance companies, he should check the premium paid, the acknowledgement receipts issued by the insurance company, the coverage of policy etc. Premium due but not paid, prepaid premium etc should be appropriately accounted.
- (vii) If the company maintains its trust for gratuity, the auditor may peruse whether the trust is an approved one under income tax law, whether the trust accounts are audited, copy of the latest accounts etc.
- (viii) The contribution should be appropriately disclosed in the accounts as per Schedule III to the Companies Act, 2013.

**(b) Expenditure Incurred for Promotion of a Product:**

- (i) The expenditure incurred for promotion of a new or existing product may entail future benefits. It may be like advertisement in the papers, television, sales exhibition, participation in trade fair, issue of promotional pamphlets, free gifts etc.
- (ii) The auditor should vouch the authority and accuracy of the transactions. He should read the contract with advertisement agencies, promotional policies decided by the management from the board minutes etc.
- (iii) He should check the amounts paid to the agencies from bank book. He should check the accuracy. He should ascertain whether tax had been deducted in accordance with the tax law provisions if any applicable in this regard.
- (iv) He should check whether the unpaid amounts and accrued liability towards promotional advertisement contracts had been duly provided for in the accounts.
- (v) The huge expenditure should not be treated as deferred revenue expenditure. According to AS 26, these are not intangible assets that may be carried over the periods of accounting. These must be expensed with in the year in which these arise.

**(c) Balance with Excise Authority:**

- (i) The balance with excise authority in PLA Account should be checked with the statements of accounts/records kept with excise section of the unit.
- (ii) The remittance into the account, the utilization out of it etc should be cross checked with bank book, clearance forms etc.
- (iii) The balance confirmation may be checked.
- (iv) The balance should be shown under current assets and advances in balance sheet.
- (v) It is to be ensured that the balances in PLA is used only to the extent of liability after adjusting Cenvat credit where available.

**(d) Receipt of Special Backward Area Subsidy from Government:**

- (i) The claim for backward area subsidy submitted to the authorities should be studied.
- (ii) It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to facto.
- (iii) The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants". The revenue grant can be taken to income statement, with appropriate disclosure.
- (iv) The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to Statement of Profit and Loss each year in proportion to depreciation of that asset charged in Statement of Profit and Loss.

- (v) The receipt of the grant should be checked with bank statement, remittance challan etc.
- (vi) The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

#### Question 20

*Gear Ltd. is engaged in manufacturing and supply of gear boxes to Indian Automobile Ltd. As per terms of supply, full price of the goods are not released by Indian Automobile Ltd. but 10% thereof is retained and paid after one year, if there is satisfactory performance of the parts supplied. Gear Ltd. accounts for only 90% of the invoice value as sale at the time of supply and balance 10% is accounted as sale in the year of receipt of payment. Comment.*

#### Answer

**Recognition of Revenue:** According to AS 9 on Revenue recognition, revenue from sale of goods should be recognised when the seller has transferred to the buyer, the property in the goods for a price or when the seller has transferred all significant risk and rewards and the seller retains no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectability.

In the given case the goods as well as the risk and ownership have been transferred by Gear Ltd., to Indian Automobile Ltd., on the basis of invoice and delivery of material.

In the instant case, therefore, Gear Ltd., should recognise sale at full 100% of the invoice value in spite of the fact that 10% payment will be released after one year. However, depending upon the past experience regarding collectability of 10% amount, they can make a provision for the amount that is not likely to be realised.

Hence, the treatment given by the company is not correct and if they do not correct it, the auditor should qualify his report.

#### Question 21

*In the course of audit of a trade, you noticed that although there is no change in either selling or purchase price of the goods, there is considerable increase in Gross Profit Ratio in comparison to previous year. What matters would you examine to assess the reason for such increase?*

#### Answer

**Increase in Gross Profit Ratio:** In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the following-

- (i) Under valuation of opening inventory due to non-inclusion of certain items or applying lower rate to one or more items of inventory.

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- (ii) Over valuation of closing inventory either by the inclusion of fictitious items or over valuing some of the items of Inventory.
- (iii) Change in the method of valuation of opening and closing inventory. For example, opening inventory was valued at lower of cost and market value, whereas closing inventory has been valued at market price which is higher than cost.
- (iv) Goods sold but not delivered are included in inventory.
- (v) Goods delivered last year but sales invoice raised in current year.
- (vi) Recording of fictitious sales to boost up profits.
- (vii) Goods returned to supplier awarding dispatch and included in closing inventory.
- (viii) Goods returned by customers but not debited to sales return and included in closing inventory.
- (ix) Inclusion in the closing inventory of goods received for sale on approval or consignment basis.
- (x) Treatment of goods sent on consignment basis as regular sales.
- (xi) Non-provision of outstanding expenses like wages, carriage inward etc.
- (xii) Wrong allocation of expenses in Trading and Profit and Loss Account.

### Question 22

*How will you vouch/verify the following:*

- (a) *Sale of Investments.*
- (b) *Payment of Revenue Expenses.*

### Answer

- (a) **Sale of Investments:**
  - (i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.
  - (ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker's sold note.
  - (iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Statement of Profit & Loss. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.
  - (iv) See that proper disclosures as required by Accounting Standard 13 on Accounting for Investments are made as follows:
    - (1) Interest, dividends, rentals on investments are to be shown in P&L A/c at Gross Value and TDS as advance tax paid.

- (2) Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

**(b) Payment of Revenue Expenses:**

- (i) See that all payments have been duly authorised by a competent authority.
- (ii) Ensure that all payments relates to business.
- (iii) Ensure that all payments have been received by the correct payee and acknowledged by a receipt note or in the voucher itself.
- (iv) See that expenses relate to the period under audit.
- (v) Ensure that no personal expenses are charged as business expenditure.
- (vi) See that all payments have been correctly recorded in the books under appropriate sub-head.
- (vii) See that if the payment relates to prior period it is classified so and the amount payable is correctly authorised.
- (viii) See mode of Payment cash, cheque etc., and relate to corresponding entry in cash or Bank book.
- (ix) Verify the cash memos, invoice with the amount paid.
- (x) Ensure that if any payment relates to period that extends to next year, a proportionate amount is carried forward as Prepaid expenses.

**Question 23**

*How would you vouch/verify the following:*

- (a) *Rental Receipts.*
- (b) *Assets acquired on Hire-purchase.*
- (c) *Cash Sales.*

**Answer**

**(a) Rental Receipts:**

- (i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.
- (ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.
- (iii) Scrutinize the account of collecting agent when the rent is collected by such agent.
- (iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.
- (v) Investigate into abnormal rent outstanding.

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- (vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.
  - (vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.
- (b) **Assets Acquired on Hire Purchase:**
- (i) Inspect the hire purchase agreement to ascertain the terms and condition, the installment and amount of interest included in the installment.
  - (ii) Ensure that these are treated as assets acquired under finance lease as per AS-19.
  - (iii) Verify that initial recognition of lease should be as an asset and a liability at equal amounts.
  - (iv) If it is reasonably certain that lessee will get ownership at the end of the term, see that asset is depreciated over its useful life. Otherwise confirm that asset is depreciated over the shorter of its useful life and the lease term.
  - (v) Ensure that it is shown separately in the Balance Sheet.
- (c) **Cash Sales:**
- (i) Examine the system of internal check to ascertain any loopholes therein.
  - (ii) Ascertain the practice followed in the matter of issuing cash memos and trace the memos into cash sale summary.
  - (iii) Ensure that the date of cash memos tally with the entry in the cash book/summary.
  - (iv) Verify that prices of goods sold have been correctly recorded and check the calculation.
  - (v) Verify the entry in the goods outward book with the sales summary.
  - (vi) See that the cancelled cash memos are not removed from the receipt book.

### Question 24

*How would you vouch/verify the following:*

- (a) *Payment of Retirement Gratuity to employees.*
- (b) *Recovery of Bad Debts written off.*

### Answer

- (a) **Payment of Retirement Gratuity to Employees:** This may be vouched in the following manner-
- (i) Examine the basis on which gratuity payable is worked out-actuarial or agreement or on the assumption that all employees retire on the balance sheet date.

- (ii) Ensure that the basis of computing gratuity is valid.
- (iii) Verify computation of liability of gratuity on aggregate basis.
- (iv) Check the amount of gratuity paid to employees who retired during the year with reference to the no. of years of service rendered by the retiring employees.
- (v) If the concern has taken an insurance policy see that the annual premium has been charged to Statement of Profit and Loss.
- (vi) Ensure that the concern has adhered to the accounting treatment in accordance with AS-15 "Employee Benefits".
- (vii) Ensure that the following disclosure requirements of Schedule III to the Companies Act, 2013 have been followed in the case of a company:

In respect of Statement of Profit and Loss, a Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:

- (i) (a) **Employee Benefits Expense** [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses];

➤ **Long-term provisions:** The amounts shall be classified as: (a) *Provision for employee benefits*; (b) Others (specify nature)

➤ **Short-term provisions:** The amounts shall be classified as: (a) *Provision for employee benefits*; (b) Others (specify nature).

- (b) **Recovery of Bad Debts Written Off:**
  - (i) Verify the relevant correspondence with the trade receivable whose accounts were written off as bad.
  - (ii) See that the amount recovered is credited to a separate account recovery of bad debts written off.
  - (iii) Verify the acknowledgement receipt issued to debtors.
  - (iv) Examine notification from the court, bankruptcy trustee and all correspondence from debtors and collecting agencies.
  - (v) Check credit manager's file for the amount received and see that the amount has been deposited in the bank promptly.
  - (vi) Review the internal control system regarding writing off and recovery of bad debts.

#### Question 25

*How will you vouch and/or verify payment of taxes?*

**Answer**

**Vouching of Payment of Taxes:**

- (i) Obtain the computation of taxes prepared by the auditee and verify whether it is as per the Income Tax Act/ Rules/ Notifications/ Circulars etc. accordingly.
- (ii) Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.
- (iii) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, notice of demand and the receipted challan acknowledging the amount paid.
- (iv) The penal interest charged for non-payment should be debited to the interest account.
- (v) Nowadays, electronic payment of taxes is also in trend. Such electronic payment of taxes by way of internet banking facility or credit or debit cards shall also be verified.
- (vi) The assessee can make electronic payment of taxes also from the account of any other person. Therefore, it should be verified that the challan for making such payment is clearly indicating the PAN No./TAN No./TIN No. etc. of the assessee on whose behalf the payment is made.

**Question 26**

*State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank.*

**Answer**

**Verification of Bank Balance of an Educational Institution:** For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:

- (i) Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.
- (ii) Check the casting, carry forwards and balancing of ledger account.
- (iii) Compare the entries in the ledger account with the bank statement.
- (iv) Review the bank reconciliation statement for its correctness.
- (v) Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.
- (vi) Verify the balance confirmation certificate.

**Question 27**

*How would you vouch/verify the following:*

- (a) *Advertisement Expenses.*
- (b) *Sale of Scrap.*

**Answer****(a) Advertisement Expenses:**

- (i) Verify the bill/invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.
- (ii) See that advertisement relates to client's business.
- (iii) Inspect the receipt issued by the agency.
- (iv) Ascertain the nature of expenditure – revenue deferred and see that it has been recorded properly.
- (v) Ascertain the period for which payment is made and see that pre-paid is carried forward to balance sheet.
- (vi) Compare the statement of account with the ledger account.
- (vii) See that all outstanding advertisement bills have been provided for.

**(b) Sale of Scrap:**

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of Scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

**Question 28**

*How would you vouch/verify the following:*

- (a) *Insurance Claim.*
- (b) *Customs Duty.*

**Answer**

- (a) **Insurance Claims:** Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims-
- (i) The auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen.
  - (ii) The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy.
  - (iii) The copy of certificate/report containing full particulars of the amount of loss should also be verified.
  - (iv) The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the Statement of Profit and Loss is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.
- (b) **Custom Duty:**
- (i) Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.
  - (ii) If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.
  - (iii) If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.
  - (iv) Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.
  - (v) Lastly, the auditor verifies the duty drawback.

**Question 29**

*On 31.12.2015, Amudhan Company Limited invested ₹ 45 lakhs in cumulative fixed deposits of Algar Bank Ltd. The deposits carry interest @10% per annum compoundable quarterly and amount of interest is added to the principal and is due and payable on the maturity date which is 5 years from the date of investments.*

*For the year ended 31st March, 2016, the company did not book any revenue of interest on the ground that interest amount is not available at their disposal till maturity date of investment. Comment.*

**Answer****Recognition of Interest on Deposits:**

- (i) Accounting Standard 9 on Revenue Recognition requires that the revenue arising from interest should be recognised on a time proportion basis taking into account the amount outstanding and the rate applicable. Such revenues should only be recognised when no significant uncertainty as to measurability or collectability exists.
- (ii) Further, according to Section 128 of the Companies Act, 2013 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.
- (iii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown as per Schedule III Part I requirement of the Companies Act, 2013.
- (iv) As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated.
- (v) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

**Question 30**

- (a) *M, Statutory Auditor of ABC Ltd. wants to verify cash on hand as on 31st March, 2016. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalized. Advise Mr. M. on how to deal with the situation.*
- (b) *As an auditor of a Limited Company, you observe that during the month of March, 2016, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts*

**Answer**

- (a) **Verification of Cash On Hand:** The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant

an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

- (b) **Manipulation of Accounts:** Accounts are falsified in order to conceal the true position of the business for some purpose. Frauds are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed-
- (i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.
  - (ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.
  - (iii) to withhold declaration of dividend even there is adequate profit.
  - (iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature-

- (i) Recording fictitious sales or omission of sales.
- (ii) Recording fictitious purchases or suppression of purchases.
- (iii) Over valuation or under valuation of inventory.
- (iv) Recording fictitious expenses or omission of expenses.
- (v) Taking credit for accrued income not likely to be received or omission of income.
- (vi) Revenue expenses changed to capital and vice-versa. SA 240 "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements" deals with the auditor's responsibilities for the detection of material misstatement resulting from fraud and error. It requires a considerable skill and vigilance on the part of an auditor. In doubtful cases he may refuse to believe the information supplied to him by any officer of the concern.

An auditor, who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

**Question 31**

*How would you vouch/verify the following:*

- (a) *Production incentive paid to workers.*
- (b) *Bad debt.*

**Answer****(a) Production Incentive Paid to Workers:**

- (i) The auditor should trace the total production incentive paid to workers from Statement of Profit and Loss to prime records/division wise/dept wise records.
- (ii) The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.
- (iii) The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.
- (iv) He should check list of payment and also acquitted disbursement slips of select departments/periods for scrutiny of various data generated in the fields for their accuracy and completeness.
- (v) The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

**(b) Bad Debts:**

- (i) The amount of bad debts should be traced to the schedule of bad debts written off during the year.
- (ii) Major amount of bad debts in the schedule be taken for scrutiny.
- (iii) Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.
- (iv) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.
- (v) The bad debts should be properly disclosed in Statement of Profit and Loss according to its materiality.
- (vi) If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

**Question 32**

*XYZ Ltd., a manufacturing concern, gave a donation of ₹ 50,000 each to a Charitable Society running a school and a trust set up for the service of blind during financial year ending on 31st*

March, 2016. The average net profits of the company for the last three years were ₹ 15 lakhs.  
Comment.

**Answer**

**Donation to Charitable Institutions:** Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bonafide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5% of its average net profits for the three immediately preceding financial years.

**Facts of the case:** In the instant case, XYZ Ltd., a manufacturing concern, has given donation of ₹ 50,000 each to two charitable organisations which amounts to ₹ 1,00,000. The average profits of the last 3 years is ₹ 15 lakhs and the 5% of this works out to ₹ 75,000. Hence the maximum of donation could be ₹ 75,000 only. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

**Conclusion:** By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence the auditor should qualify his audit report accordingly.

**Question 33**

*How would you vouch/verify the following:*

- (a) Goods sent out on Sale or Return Basis.
- (b) Bank overdraft.

**Answer**

**(a) Goods Sent Out on Sale or Return Basis:**

- (i) A record of goods sent out on sale or return basis should be kept in a specially ruled day book. In this book, first memoranda entries are made.
- (ii) When the goods are sold, entry is made by debiting the party and crediting the Sales Account.
- (iii) The auditor should refer the memoranda record to confirm that on receipt of acceptance from each party, his account is debited and corresponding sales account is credited.
- (iv) For the goods in respect of which period of approval has expired are either received back subsequently and customer's accounts debited.
- (v) He should ensure that for the inventory of goods sent out on approval, the period of approval, in respect of which had not expired till the close the year, are included in closing inventory.

**(b) Bank Overdraft:**

- (i) The auditor should ensure that the facility of overdraft is authorised by the Board's resolution / partner's resolution.
- (ii) Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company's property.
- (iii) Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.
- (iv) Verify the rate of interest and other terms and conditions from the agreement.
- (v) Verify the amount of overdraft from the books of accounts and compare it with the passbook.
- (vi) If the overdraft is against hypothecation of assets like inventories, a certificate from the bank should be obtained.
- (vii) If the overdraft is against hypothecation of assets or pledge of company's property, see that overdraft is properly shown under 'secured loans' and nature of security has been properly disclosed.

**Question 34**

*A trader is worried that inspite of substantial increase in sales compared to earlier year, there is considerable fall in Gross Profit. After satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants to ensure that purchases have been truthfully recorded.*

*How will you proceed with this assignment?*

**Answer**

There are three steps involved in such an assignment:

- A. Study and evaluation of internal control system
- B. Vouching of purchase transactions
- C. Analytical procedures
- A. Study and evaluation of internal control system

This involves the following steps:

- (i) **Internal check:** It should consist of the segregation of duties at the following points:
  - (a) **Requisitioning the goods:** Specified employees from the stores department or from the production department's store unit should prepare and approve a purchase requisition for raw materials or goods used in production. The purchase requisition is sent to the purchase department.
  - (b) **Ordering the goods requisitioned:** The purchase department is responsible for negotiating the best prices, fixing delivery dates with suppliers and ensuing

that appropriate quality goods are obtained. It should prepare a serially numbered purchase order.

- (c) **Receiving the goods ordered:** Goods ordered should be inspected and counted by the receiving department. If satisfied, it prepares serially numbered receiving report or goods received note and forwards its notification copies to the stores, purchase department and finance department.
  - (d) **Preparing the payment voucher:** The accounts payable department or accounts payable unit of finance department will receive the invoices and process for its payment and accounting.
- (ii) **Physical controls**
- (a) Physical controls over inventory include locked warehouses and store-rooms and limiting access to them to authorised personnel and
  - (b) Printed and pre-numbered forms should be used for purchase requisitions, purchase orders, receiving reports and vouchers.
- (iii) **Authorised procedures**
- (a) Re-order points should be established for various inventory items that may trigger a manual request.
  - (b) Authorisation procedures should be designed for all the four control points – requesting the goods, ordering the goods requisitioned, receiving the goods ordered and preparing the payment voucher.
- (iv) **Internal review**
- (a) It should ensure that there is adequate separation of duties and proper authorisation procedures with regard to processing and recording of purchase transactions.
  - (b) Paid invoices should be reviewed to ascertain the accuracy of the recording of these invoices and if possible, these invoices should be traced back to purchase requisition through receiving reports or goods received notes and purchase orders.

**B. Vouching of purchases transactions**

The auditor should vouch credit purchases in the following manner:

- (i) **Examine purchase book:** The auditor should examine the transactions recorded in the purchase book with reference to related purchase invoice.
- (ii) **Examine purchase invoices:** The auditor should select a small sample of vendors' invoices at random and should conduct in-depth audit on them i.e., trace the transaction from placing the order to the entries in inventory goods for actual receipt and payment made to the suppliers. In respect of imports, documents such as bill of

lading, customs clearance, etc. should be examined. The auditor should ensure that subsidies, rebates, duty drawbacks or other similar items have been properly accounted for.

- (iii) **Examine the numerical sequence of source documents:** The auditor should ensure the numerical sequence of source documents such as purchase requisitions, purchase orders, receiving reports and vouchers have been maintained and missing numbers have been duly accounted for.
- (iv) **Examine cut off points:** In order to ensure that purchases were recorded at that point of time when title was passed to the client, the auditor should examine cut-off points on pre-numbered purchase requisitions, purchase orders and goods received notes. The auditor should, then, trace the goods received notes pertaining to a few days before the end of the period under audit to the related purchase invoices. Such a comparison would ensure that purchases represented by such invoices have been recorded as the purchases of the period under audit.
- (v) Examine transition with related parties carefully.

#### C. Analytical procedures

The auditor should compare item-wise and location-wise both quantity and value of purchases for the current period with the corresponding figures for the previous period and ensure that major variations are explained and justified. Various analytical ratios should also be calculated and compare.

#### Question 35

*What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance?*

#### Answer

**Auditing an Account of Bought Ledger:** The structure of every account in the Bought Ledger is - opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

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In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule III to the Companies Act, 2013. The maximum amount due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed along with the names of companies (Part I, Schedule III to the Companies Act, 2013).

#### Question 36

*List out some examples of fraud that can be done by ledger keeper in Bought ledger and sales ledger.*

#### Answer

**Ledger Keeper and Frauds:** Examples of frauds that can be done by ledger keeper in bought ledger-

- (i) Crediting the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the credit in the supplier's accounts.
- (ii) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier's credit.
- (iii) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

**Examples of frauds that can be done in sales ledger:**

- (i) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

- (ii) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the trade receivable, misappropriating an amount equivalent to the credit.
- (iii) Writing off the amount receivable from a customer's bad debt account and misappropriating the amount received in payment of the debt.

### Question 37

*Give various factors which result in increase in Gross profit.*

### Answer

#### Factors Which Increases the Gross Profit:

- (i) Undervaluation of opening inventory; it may be either the effect of non-inclusion of certain items of inventories or that of valuation of the inventory at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of inventory. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.
- (ii) Overvaluation of closing inventory, either by the inclusion therein of fictitious items of inventory or over-statement of values of some of them.
- (iii) Alteration of the basis of valuation of closing inventory, e.g., where the opening inventory was valued at cost or market rate whichever was lower, valuing the closing inventory at the market price which is higher than cost.
- (iv) Increase in the value of some of the items included in the opening inventory above cost, on account of which the unsold inventory of these items at the close of the year is valued at cost.
- (v) Under-statement of opening inventory or over-statement of closing inventory, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing inventory or when goods were delivered and taken out of inventory last year, but sales invoices is raised in the current year.
- (vi) Entry of fictitious purchases to boost up the profits, if such a practice has been resorted to, it would have the effect of reducing the rate of gross profit in the ensuing year.
- (vii) Inclusion in the closing inventory of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by customers, the cost whereof has not been credited to parties.
- (viii) Inclusion in the closing inventory of goods received for the sale on approval or on a consignment basis.
- (ix) Treatment of goods sent out for sale on consignment basis as regular sales.

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- (x) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.
- (xi) Wrong allocations of expenses, e.g., carriage inwards either in whole or in part may be wrongly taken to the Profit and Loss Account.

### Question 38

*What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".*

### Answer

**Extent of Reliance on Analytical Procedures (SA-520):** The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures-

- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing.

### Question 39

*What are the factors to be considered while "Vouching of travelling expenses"?*

**Answer**

**Vouching of Travelling Expenses:** The following factors are to be considered while “Vouching of Travelling Expenses”-

- (i) Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.
- (ii) As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.
- (iii) The voucher for travelling expenses should normally contain the under mentioned information:
  - (1) Name and designation of the person claiming the amount.
  - (2) Particulars of the journey.
  - (3) Amount of railway or air fare.
  - (4) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.
  - (5) Other expenses claimed
- (iv) If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source.
- (v) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified.
- (vi) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.
- (vii) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

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- (viii) Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

#### Question 40

*How will you vouch and verify the following:*

- (a) *Remuneration paid to directors.*
- (b) *Profit or loss arising on sale of plots held by real estate dealer.*
- (c) *Purchase with invoice.*
- (d) *Wages paid to seasonal labourer.*
- (e) *Refund of General Insurance Premium paid.*

#### Answer

##### (a) Remuneration Paid to Directors:

- (i) Refer to General Meeting or Board meeting resolution for the appointment and terms of appointment of the director as per Section 196 of the Companies Act, 2013.
- (ii) Examine Articles of Association and general meeting resolution to determine the manner of payment- monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197(6) of the Companies Act, 2013.
- (iii) Check agreement with the director.
- (iv) Verify director's attendance in the board meetings.
- (v) Ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013, where appropriate.
- (vi) Check computation of the net profits and the commission payable to directors in terms of Schedule III to the Companies Act, 2013.
- (vii) Computation of net profit under section 198 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any) should be stated by way of note.

- (b) **Profit or Loss Arising on Sale of Plots Held by Real Estate Dealer:** The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value, whichever is less.

Profit or loss arising on sale of plots of land by Real Estate Dealer should be verified as follows-

- (i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the

appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

- (ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.
  - (iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
  - (iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
  - (v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.
  - (vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.
- (c) **Purchase with Invoice:** While vouching entries for purchases with the invoices, the following points should be specially observed-
- (i) that the date of invoice falls within the accounting period;
  - (ii) that the invoice is made out in the name of the client;
  - (iii) that the supplier's account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;
  - (iv) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;
  - (v) that the cost of purchases has been debited to an appropriate nominal account or accounts;
  - (vi) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and
  - (vii) that the manager or some other official, competent to sanction payment, has authorised its payment.

- (d) Wages Paid to Seasonal Labourers:
- (i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.
  - (ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.
  - (iii) Ensure that the attendance is properly checked by the Time Keeping Department.
  - (iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.
  - (v) Check the computation of wages payable to the labourers, after taking into account the deductions.
  - (vi) Confirm that all the payments to the labourers have been acknowledged.
  - (vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.
  - (viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.
- (e) Refund of General Insurance Premium Paid: The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds-
- (i) Ascertain the reasons for refund of insurance premium.
  - (ii) Examine insurance policy or cover note to find out the amount of premium.
  - (iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.
  - (iv) Scrutinise correspondence between the insurance company and the client.
  - (v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

**Question 41**

*As an auditor, what are the essential points to be borne in mind while examining a voucher?*

**Answer**

**Examining a Voucher:** The essential points to be borne in mind while examining a voucher are-

- (i) that the date of the voucher falls within the accounting period;
- (ii) that the voucher is made out in the client's name;
- (iii) that the voucher is duly authorised;
- (iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
- (v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

**Question 42**

*Indicate expenses which are essentially of a revenue nature, if incurred for creating an asset, are also regarded as expenditure of a capital nature.*

**Answer**

**Expenses which are essentially of a revenue nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are also regarded as expenditure of a capital nature.**

**Examples-**

- (i) **Material and wages:** capital expenditure when expended on the construction of a building or erection of machinery.
- (ii) **Legal expenses:** capital expenditure when incurred in connection with the purchase of land or building.
- (iii) **Freight:** capital expenditure when incurred in respect of purchase of plant and machinery.
- (iv) **Repair:** Major repairs of a fixed asset that increases its productivity.
- (v) **Wages:** Wages paid on installation costs incurred in Plant & Machinery.
- (vi) **Interest:** Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalized, it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

**Question 43**

*Casting or totaling is an important tool of audit for an Auditor. Comment.*

**Answer**

**Casting or Totaling as an Audit Tool:** Casting or totaling is an important tool of audit for an auditor as sometimes the totals of a wage bill are inflated by over totaling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from account receivables by under-totalling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totaling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked.

On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totaling mistakes being discovered.

Sometimes a fraud is committed in the following manner-

- (a) under casting the receipt side of the cash book;
- (b) Over casting the payment side of the cash;
- (c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;
- (d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and
- (e) wrong totals or balances being carried forward in the cash book or in the ledger.

**Question 44**

*What procedure an auditor should adopt to test the authenticity of cash at bank?*

**Answer**

**Verification of Cash at Bank:** While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

- (i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding

items from the management. He should also examine whether any such items require an adjustment write-off.

- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.
- (vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.
- (vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.
- (viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.
- (ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.
- (x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

#### Question 45

*Janta Ltd. has made a contribution of ₹ 7.8 lacs during the financial year ended 31.3.16 to Samaj Seva Party, a political party, for running a teaching institute situated in the rural area, where most of the workers of the company reside. It is admitted that the benefit of the institute is mostly for the children of the workers of the company. The average net profit of the company during the three immediately preceding financial years was ₹ 100 lakhs. Comment.*

#### Answer

**Restrictions Regarding Political Contribution:** Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, aggregate contribution in any financial year should not exceed 7½ % of average net profit during the three immediately preceding financial years.

In the given case, Janta Ltd. has made a contribution of ₹ 7.8 lacs to Samaj Seva Party, a

political party. The average net profit of the company during the three immediately preceding financial years is ₹ 100 lakhs and the 7½ % of this works out to ₹ 7.5 lacs.

As the company has contributed ₹ 7.8 lacs, there is a violation of the provisions of Section 182 of the Companies Act, 2013 although the children of its workers are benefited. Therefore, the auditor would have to qualify his report accordingly.

**Question 46**

*How will you vouch/verify Repair to Assets?*

**Answer**

*Repair to Assets:*

- (i) Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost.*
- (ii) It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life should be treated as capital expenditure.*
- (iii) Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained.*
- (iv) It should be ensured that Repairs to 'Certain Assets' like Building and Machinery have been separately disclosed as per the requirements of Schedule III to the Companies Act, 2013.*

**Question 47**

*Point out any eight areas where external confirmation used as an audit procedure.*

**Answer**

*External Confirmation as an Audit Procedure: SA 505, "External Confirmations", lays down standards for external confirmation of balances. External confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other areas where external confirmations may be used include the following:*

- *Bank balances and other information from bankers.*

- *Accounts receivable balances.*
- *Inventories held by third parties.*
- *Property title deeds held by third parties.*
- *Investments purchased but delivery not taken.*
- *Loans from lenders.*
- *Accounts payable balances.*
- *Long outstanding share application money.*

Question 48

*Write short notes on the following:*

- (a) *Remuneration paid to directors in case of a public limited company.*
- (b) *Payment for acquisition of assets.*

*Answer*

- (a) *Remuneration Paid to Directors: The following points must be considered regarding the directors' remuneration in case of a public company–*
  - (i) *Examine the Entitlement: The directors are not automatically entitled to remuneration. It is paid either according to the terms of articles of association or in accordance with a resolution of the general meeting.*
  - (ii) *Examine Adherence to Legal Provisions: The auditor should examine adherence to relevant sections of the Act such as –*
    - (1) *Section which deals with manner of payment of managerial remuneration.*
    - (2) *Section which deals with payment of sitting fees.*
    - (3) *Section which has prescribed the overall limit to managerial remuneration.*
    - (4) *Schedule V to the Companies Act, 2013 that has laid down conditions for payment of remuneration for companies having no profits or inadequate profits and companies having negative effective capital.*
    - (5) *Proviso to section which provides for increase in remuneration with the approval of the Central Government.*
- (b) *Payment for Acquisition of Assets: The following points must be considered regarding payment for acquisition of assets–*
  - (i) *The purchase of an asset must be duly supported by the receipt for the amount paid.*
  - (ii) *In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore*

*essential for an auditor to see that property has been registered in the purchaser's name as required by the relevant regulations and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.*

- (iii) In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired.*
- (iv) It must also be verified that the assets were purchased only by a person who had the authority to do so. Companies Act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset.*
- (v) If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired.*
- (vi) In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads.*
- (vii) It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.*

### Exercise

- 1 As an auditor, comment on the following situations/statements:
  - (a) An assistant of X & Co. Chartered Accountants wanted to verify the cash in hand and investments of T Ltd. The General Manager (Finance) of T Ltd. suggested to the assistant of X & Co. that it was not necessary as his staff had done the same only few days back and no discrepancies were noted.
  - (b) Z Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch new product as Revenue Expenditure. The product did not pick up and the sales were negligible.
  - (c) Z Ltd. acquired a car for its managing Director on Hire-purchase basis. The interest payable as well as penalty payable for late payment of installments was added to the cost of the car.
  - (d) The sale proceeds from scrap which did not have significant value need not be verified if the company had a god accounting and costing system.
- 2 A trader is worried that in spite of substantial increase in sales as compared to the earlier year there is considerable fall in gross profit. After satisfying him that sales and expenses are correctly

*recorded and that the valuation of inventories is on consistent basis, he wants you to ensure the purchase have been truthfully recorded. In the circumstances, how you would proceed with the assignment?*

- 3 *How would you verify and vouch the following?*
  - (a) *Income-tax Payment.*
  - (b) *Bills Receivable.*
  - (c) *Outstanding liabilities for expenses.*
  - (d) *Sale proceeds of Rejected Materials.*
  - (e) *Consignment transactions in the books of consignee.*
  - (f) *Interest and Dividends received.*
  - (g) *Empties or Containers.*
- 4 *State briefly the audit objectives of the following:*
  - (a) *Examination of Bank Reconciliation Statement.*
  - (b) *Reconciliation of the aggregate balances of the individual Sales Ledgers with the Sales Ledger Control Account.*
  - (c) *Review of the work performed by the different personnel of the Cash Department.*